U.S. Supreme Court Hears Oral Arguments in Dormant Commerce Clause Case

November 21, 2014

Overview

On November 12, 2014, the U.S. Supreme Court heard oral arguments in *Comptroller of the Treasury of Maryland v. Wynne* ("*Wynne*"),[1] a case involving Maryland's individual income tax regime, which is comprised of two components - a "State" income tax and a "County" income tax.[2] Under that tax regime, Maryland residents may take a credit against the "State" tax, but not against the "County" tax, for income taxes paid on income earned in and taxed by other states.[3] The issue before the Supreme Court is whether Maryland's failure to allow a credit against the "County" portion of the tax violated the U.S. Constitution.

In this Tax Alert we summarize the Maryland court decisions and the parties' arguments before the U.S. Supreme Court. We also provide some taxpayer considerations, including the potential broader implications that this case may have on the dormant Commerce Clause.

Background

In *Wynne*, the taxpayers, a Maryland couple, earned income through a Maryland-based S corporation. A substantial portion of that income was earned from and taxed in jurisdictions outside of Maryland. On their Maryland personal income tax return, the taxpayers credited against both the Maryland "State" and "County" tax liability the tax amounts paid to other states. Under Maryland's partial-credit regime, as administered by the Maryland Comptroller ("Comptroller"), Maryland residents may credit income taxes paid to other states against their Maryland "State" tax but not the "County" tax.[4] On audit, the Comptroller determined that the taxpayers had underpaid their 2006 state personal income taxes by claiming a credit against their "County" tax. On that basis, the Comptroller issued a deficiency assessment. The taxpayers appealed, claiming that the partial-credit regime was unconstitutional.

Maryland Court Decisions

On appeal, the Maryland Tax Court held for the Comptroller and upheld the partial-credit regime. The Howard County Circuit Court reversed the Tax Court's decision, thus holding in favor of the taxpayers. The Maryland Court of Appeals (Maryland's highest court) affirmed the Circuit Court's decision and held that the Maryland tax regime is unconstitutional because it violates the dormant Commerce Clause.

Under the Court of Appeals' analysis, Maryland's tax regime failed the second and third prongs of the test for satisfaction of the dormant Commerce Clause as set forth in *Complete Auto Transit Inc. v. Brady*,[5] namely, "(2) [the tax must be] fairly apportioned; [and] (3) [the tax must not be] discriminatory towards interstate commerce."[6] In addressing the fair apportionment prong of *Complete Auto*, the Maryland Court of Appeals held that the tax lacked both internal and external consistency. If every state were to adopt a partial-credit regime, taxpayers may be subject to uncreditable taxes in multiple states on the same income.[7] Thus, the tax lacked internal consistency.

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[1] *Comptroller of the Treasury of Maryland v. Wynne*, No. 13-485 (U.S. argued Nov. 12, 2014).
[2] Md. Code Ann., Tax-Gen. §§ 10-102, 10-103(a)(1). It should be noted that the Maryland Supreme Court has previously held that both taxes are state taxes; that the County tax is applied locally has no bearing on its characterization. *See*, *Frey v. Comptroller of Treasury*, 29 A.3d 475, 492 (Md. 2011).
[3] Md. Code Ann., Tax-Gen. § 10-703(a).
[4] *Id*.
[5] 430 U.S. 274, 279 (1977).
[6] *Comptroller of the Treasury of Maryland v. Wynne*, 431 Md. 147, 165 (Md. 2013), *cert. granted,* 134 S. Ct. 2660 (2014), citing *Complete Auto*, 430 U.S. at 279.
[7] *Wynne*, at 166-167.

The Maryland Court of Appeals held that the partial-credit regime lacked external consistency because it applies the County tax to income generated solely in other states, without an appropriate credit.[8]

Regarding the third prong of *Complete Auto*, which asks whether a state tax discriminates against interstate commerce or otherwise unduly burdens interstate commerce,[9] the Court of Appeals held that Maryland's tax failed because it subjects income earned outside Maryland to a higher rate than income earned within Maryland.[10] The Maryland Court of Appeals found this discrimination impermissible.[11]

The Comptroller subsequently petitioned the U.S. Supreme Court for a writ of certiorari to review the judgment of the Maryland Court of Appeals. The U.S. Supreme Court granted review. The issue before the Supreme Court is whether Maryland's failure to allow a credit against the "County" portion of the tax violated the U.S. Constitution.

Comptroller's Arguments before the U.S. Supreme Court

Much of the focus of counsel for the Comptroller in the oral argument was on the states' power generally to tax residents' income, wherever earned. With this as a foundation, counsel argued that Maryland should be permitted to tax residents to ensure they pay their fair share of tax and help fund the benefits they receive from Maryland by virtue of residing within the state. According to counsel, the partial-credit regime is justifiable and fair because it allows residents to credit, in its entirety, the state tax component of the Maryland income tax if they pay sufficient tax to other states.

In support of the position that the partial-credit regime does not discriminate under the dormant Commerce Clause, counsel for the Comptroller stated, "the chief concern this Court has articulated [in] its dormant Commerce Clause . . . jurisprudence, that is, protecting against measures that are protectionist in nature and benefit in-staters at the expense of out-of-staters[,] is not present here. There is no discrimination or extraterritorial overreaching . . . ."[12] Counsel also argued that the Commerce Clause does not require states to subordinate their income tax claims on their residents' income to those of other states "just because another state, exercising an equally legitimate taxing power, but on a very distinct ground, is taxing a portion of that income merely because it was earned within that state's borders."[13] When probed by the Justices regarding whether the partial-credit regime fails the internal consistency test, counsel responded in the negative, stating "the proper construction of that test in this situation asks about the internal consistency of the rationale that Maryland is advancing, that is, are we being consistent in our structure – in structuring our tax so that it reaches residents on their entire income regardless of [where] it's earned."[14]

Additionally, in an oral argument given as amicus curiae, the Assistant to the Solicitor General for the United States (the "Assistant") asserted that when two taxes are imposed on the same income by two different states, it is not impermissible double taxation under the Commerce Clause if the taxes are based on distinct jurisdictional rationales.[15] The Assistant argued further that that "is what we have here. One is a tax based on residency and the other is a tax based on doing business in the state."[16]

Taxpayers' Arguments before the U.S. Supreme Court

The taxpayers' central argument is that Maryland's tax regime unduly burdens interstate commerce and thus violates the dormant Commerce Clause because it subjects resident taxpayers to multiple taxation on income earned from sources outside of Maryland. A continuing theme throughout oral argument presented by counsel for the taxpayers is that Maryland is the outlier. All other states provide their residents with a full credit for the individual income taxes paid on out-of-state income to other states.

In supporting his position, counsel for the taxpayers explained that this is not a question of Due Process, as "States have the raw power, right . . . to reach their residents' income wherever earned."[17] This is instead a matter of the

[8] *Id.* at 172.
[9] *Complete Auto*, 430 U.S. at 279.
[10] *Wynne*, 431 Md. at 176.
[11] *Id.*
[12] Transcript of Oral Argument at 16, *Comptroller of the Treasury of Maryland v. Wynne*, U.S. (No. 13-485), available at **http://www.supremecourt.gov/oral_arguments/argument_transcripts/13-485_3f14.pdf**.
[13] *Id*. at 3.
[14] *Id*. at 15.
[15] *Id*. at 24-25.
[16] *Id.*
[17] *Id*. at 38.

Commerce Clause, which draws a constitutional line when it comes to state taxation and “it’s the line the internal consistency test draws, . . . that we’re not going to allow states to structure their taxes so that they are . . . exposing income to more than 100 percent of the tax base.”[18] When probed by the Justices on how the internal consistency test should be applied, counsel argued that the whole tax, both the resident and non-resident portions, must be analyzed.[19] In describing the partial-credit regime and it its tendency for double taxation, counsel likened the tax to a tariff that “is the quintessential unlawful tax under the dormant Commerce Clause.”[20] Counsel further asserted, based on Supreme Court precedent and in direct contrast to the Comptroller’s position, that “in a situation where one state is taxing on the basis of residency and the other on the basis of source, it is the state of residency that yields.”[21] In closing, counsel harkened back to one impetus behind the drafting of the Constitution when he stated, “States have some limitations on what they can do with taxation under the Commerce Clause, but what they bought in exchange for . . . agreeing to those limitations in the Constitution is a nationwide network of commerce.”[22]

Considerations

Maryland taxpayers may wish to review their positions with respect to income sourced outside of Maryland and consider filing protective refund claims, pending the Court’s decision in this case. Maryland taxpayers, who filed protective refund claims on this issue, should also be aware that, in May, Maryland adopted into law S.B. 172, which included provisions reducing the interest rate (below the state’s statutory rate) on potential refunds that may arise from this case.[23]

Also, taxpayers that conduct business in multiple U.S. states may wish to follow the proceedings in this case, which could have further implications. A holding in favor of the Comptroller could potentially serve as a basis for other states to change their current credit regimes and adopt partial-credits that mirror Maryland’s in an effort to increase state revenue. A pro-Maryland decision may also portend changes to other compensatory credit regimes, such as those involving sales and use taxes. Finally, some commentators have suggested that a decision in this matter may have broader implications on the dormant Commerce Clause, potentially changing years of state taxation history. Of interest in this regard is that Justices Scalia and Thomas have questioned the validity of the dormant Commerce Clause concept.

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[18] *Id*. at 29.
[19] *Id*. at 37.
[20] *Id*. at 28.
[21] *Id*. at 35.
[22] *Id.* at 50.
[23] S.B. 172, 2014 Leg., 431st Sess. (Md. 2014).